

Message Text

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PAGE 01 OTTAWA 03782 01 OF 02 112203Z

ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-07 FRB-03

INR-07 NSAE-00 USIA-06 TRSE-00 XMB-02 OPIC-03

SP-02 LAB-04 EPG-02 SIL-01 OMB-01 DODE-00 PM-04

H-01 L-03 NSC-05 PA-01 PRS-01 SS-15 /086 W

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R 112148Z MAY 77

FM AMEMBASSY OTTAWA

TO SECSTATE WASHDC 3430

INFO AMCONSUL MONTREAL

USMISSION OECD PARIS

ALL OTHER AMCONSULS CANADA (POUCH)

LIMITED OFFICIAL USE SECTION 01 OF 02 OTTAWA 03782

DEPT PASS TREASURY, FRB

E.O. 11652: N/A

TAGS: EFIN, CA

SUBJECT: FINANCIAL DEVELOPMENTS: BANK RATE LOWERED

REF: OTTAWA 458

1. SUMMARY: WITH MONEY SUPPLY GROWTH BELOW TARGET AND THE ECONOMY WEAK, BANK OF CANADA LOWERED BANK RATE FROM EIGHT TO SEVEN AND ONE HALF PERCENT EFFECTIVE MAY 9. FEDERAL POLICIES ARE LEANING TOWARDS ENCOURAGING DOMESTIC FINANCIAL MARKETS BY STRENGTHENING LONGER TERM END OF DOMESTIC BOND MARKET AND STIMULATING EQUITY FINANCING. END SUMMARY.

2. REASON GIVEN BY GOVERNOR BOUEY FOR BANK RATE REDUCTION EFFECTIVE MAY 9 WAS THAT RATE OF INCREASE OF THE MONEY SUPPLY (M-1, DEFINED AS CURRENCY AND DEMAND DEPOSITS AT THE CHARTERED BANKS) HAS BEEN BELOW THE BANK'S TARGET

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PAGE 02 OTTAWA 03782 01 OF 02 112203Z

RANGE OF 8 TO 12 PERCENT ANNUALLY. BOUEY ADDED THAT THERE WAS NOW ROOM FOR SOME DECLINE IN SHORT-TERM RATES FROM PRESENT LEVELS WITHOUT RUNNING THE RISK THAT OVERLY-RAPID MONETARY EXPANSION WOULD JEOPARDIZE CONTINUING PROGRESS IN MODERATING INFLATION. IN ADDITION, HE NOTED CANADA'S ECONOMIC SITUATION AND PROSPECTS "CLEARLY MAKE IT VERY DESIRABLE" THAT INTEREST RATES BE NO HIGHER THAN

NECESSARY.

3. ALTHOUGH SEASONALLY-ADJUSTED M-1 INCREASED 10.2 PERCENT DURING THE FIRST QUARTER, M-1 GROWTH HAS CONTINUED NEAR OR BELOW THE LOW END OF THE TARGET RANGE ANNOUNCED LAST AUGUST OF 8 TO 12 PERCENT GROWTH ANNUALLY, BASED ON THE THREE MONTHS CENTERED ON MARCH 1976. M-1 GROWTH DURING THE TWELVE MONTHS OF 1976 WAS 7.9 PERCENT AND SEVEN PERCENT FOR THE TWELVE MONTHS ENDING MARCH 1977. UNADJUSTED FIGURES SO FAR AVAILABLE FOR APRIL SHOW A DECLINE DURING THAT MONTH.

4. WHILE CANADA IS STILL EXPERIENCING INFLATIONARY PROBLEMS AS SHOWN BY THE TWO PERCENT JUMP IN WHOLESALE PRICES IN MARCH (OTTAWA 3558), HIGHER COMMODITY PRICES, ESPECIALLY FOR FOOD AND FUEL, ARE GENERALLY BLAMED FOR THE RECENT SPURT. GOVERNOR BOUEY NOTED IN HIS STATEMENT THAT WHILE THE RECENT TREND IN PRICES HAD BEEN UNFAVORABLE, HE WAS CONFIDENT THAT THE UNDERLYING MOVEMENT TOWARDS LOWER RATES OF INFLATION WOULD RESUME BEFORE LONG. IN THIS CONNECTION HE NOTED "CONTINUING MODERATION" IN THE AVERAGE SIZE OF WAGE AND SALARY INCREASES. (NEW ONE YEAR WAGE SETTLEMENTS AVERAGED 8.6 PERCENT IN THE FIRST QUARTER, UP FROM 8.2 PERCENT IN THE FOURTH QUARTER OF 1976, BUT FAR BELOW THE 14.2 PERCENT INCREASE IN THE FIRST QUARTER OF 1976. NEW WAGE SETTLEMENTS IN MANUFACTURING WERE UP 6.6 PERCENT IN THE FIRST QUARTER, AND 6.1 PERCENT IN THE PREVIOUS QUARTER.)

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PAGE 03 OTTAWA 03782 01 OF 02 112203Z

5. THIS REDUCTION IN THE BANK RATE IS THE FOURTH SINCE NOVEMBER 22, THE MOST RECENT BEING ON FEBRUARY 1 (SEE REFTEL). IN ADDITION TO LOW M-1 GROWTH, FACTORS WHICH MAY HAVE CONTRIBUTED TO ANOTHER REDUCTION NOW INCLUDE A DROP IN SEASONALLY-ADJUSTED GENERAL LOANS IN APRIL FOR THE FIRST TIME IN MORE THAN TWO YEARS; A SOMEWHAT STRONGER CANADIAN DOLLAR IN APRIL COUPLED WITH AN INCREASE IN RESERVES LAST MONTH (OTTAWA 3638); AND INTEREST RATES IN THE U.S. WHICH HAVE NOT RISEN AS MUCH AS SOME HAD EXPECTED A FEW MONTHS AGO, KEEPING U.S. AND CANADIAN INTEREST RATE DIFFERENTIALS SOMEWHAT LARGER THAN ANTICIPATED. IN ADDITION, THE CANADIAN ECONOMY REMAINS SLUGGISH. THE BANK OF CANADA NO DOUBT WAS AWARE LATE LAST WEEK OF THE UNEMPLOYMENT FIGURES FOR APRIL, RELEASED MAY 10, SHOWING AN INCREASE IN UNEMPLOYMENT FROM 8.1 TO 8.3 PERCENT (SEE SEPTTEL).

6. THE REDUCTION SURPRISED SOME TRADERS WHO DID NOT EXPECT A REDUCTION BEFORE THE DOLS 600 MILLION FEDERAL

BOND ISSUE OFFERED MAY 2 WAS DELIVERED MAY 16. THE BANK IS EVIDENTLY NOT OVERLY CONCERNED ABOUT CHANGING THE RATE BETWEEN OFFERING AND DELIVERY DATES, EVEN THOUGH THE BANK RATE REDUCTION WILL GIVE PURCHASERS A SMALL IMMEDIATE GAIN.

7. GIVEN THAT MONETARY POLICY CHANGES TAKE A LONG TIME TO INFLUENCE THE ECONOMY, SOME ANALYSTS HAVE BEEN QUOTED AS BEING CRITICAL OF THIS RATE REDUCTION, BELIEVING THAT THE BANK OF CANADA SHOULD HAVE WAITED LONGER TO GAUGE THE PAST THREE REDUCTIONS SINCE NOVEMBER. DESPITE THE LOW APRIL FIGURES WOOD GUNDY OF TORONTO HAS PREDICTED A REACCELERATION OF M-1 GROWTH TO OVER 10 PERCENT DURING THE NEXT

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PAGE 01 OTTAWA 03782 02 OF 02 121355Z
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LIMITED OFFICIAL USE SECTION 02 OF 02 OTTAWA 03782

SEVERAL MONTHS, EVEN WITHOUT A FURTHER BANK RATE REDUCTION. THIS WOULD BRING M-1 INTO THE TARGET RANGE OF ABOVE 8 PERCENT BY THE SUMMER.

8. CRITICS ALSO FEAR THAT LOWER RATES WILL NOT INDUCE MUCH MORE INVESTMENT OVER THE SHORT RUN, WHILE GENERATING MORE UNCERTAINTY ABOUT INFLATION. THE HEALTHY TRADE SURPLUS IN MARCH AND STRONGER DOLLAR IN APRIL ARE VIEWED AS REFLECTING LITTLE FUNDAMENTAL IMPROVEMENT IN CANADA'S BALANCE OF PAYMENT PROBLEMS, AS MOST OF THE SURPLUS WAS THE RESULT OF HIGHER EXPORTS OF PRIMARY COMMODITIES RATHER THAN OF MANUFACTURED GOODS IN WHICH CANADIAN

COMPETITIVENESS REMAINS WEAK. ON THE OTHER HAND, WITH INFLATION NOW BEING FUELED MOSTLY BY COMMODITY PRICES AND TO A LESSER DEGREE BY THE LOWER EXCHANGE RATE FOR THE CANADIAN DOLLAR THIS YEAR IN CONTRAST TO 1976, IT DOES NOT SEEM LIKELY TO THE EMBASSY THAT LOWER INTEREST RATES NOW HAVE MUCH PROBABILITY OF ADDING TO INFLATIONARY PRESSURES.

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PAGE 02 OTTAWA 03782 02 OF 02 121355Z

9. IMMEDIATE EFFECTS OF THE LOWERING OF THE BANK RATE WERE PREDICTABLE, BUT NOT DRAMATIC. THE CANADIAN DOLLAR SLID MAY 9 ONLY ABOUT TWO-TENTHS OF A PERCENT FROM U.S. DOLS .9553 ON FRIDAY'S CLOSE TO .9532 AT COB MONDAY. THE STOCK MARKET STAGED A RALLY IN EARLY TRADING BEFORE FALLING BACK DUE TO LOWER PRICES IN NEW YORK. EIGHT CHARTERED BANKS ANNOUNCED A DECREASE IN THEIR PRIME LENDING RATE TO 8.25 PERCENT FROM 8.75 PERCENT, BUT MADE THAT DECREASE EFFECTIVE JUNE 1 WHEN INTEREST THEY PAY ON NON-CHECKING SAVINGS WILL ALSO BE DECREASED TO 5.75 FROM 6.25 PERCENT. BOND YIELD DECLINES WERE LARGER THE SHORTER THE TERM OF THE BONDS. YIELDS ON 30 DAY COMMERCIAL PAPER AND MANY BOND PRICES MAY 9 GAVE UP 25 TO 38 BASIS POINTS.

10. FEDERAL DEBT MANAGEMENT POLICIES (TO BE SUBJECT OF SEPTTEL) HAVE BEEN TO INCLUDE LONG TERM BONDS AS PART OF RECENT FEDERAL ISSUES IN ORDER TO GIVE SOME VITALITY AND DEPTH TO THE PRIVATE LONG TERM DOMESTIC BOND MARKET. IN ADDITION, GOC SOUGHT IN ITS MARCH 31 BUDGET TO STRENGTHEN DOMESTIC EQUITY MARKETS WHICH HAVE LONG BEEN PLAGUED BY LOW RATES OF RETURN ON EQUITY AND LOW STOCK PRICES SINCE THE END OF THE RECESSION. LOWER TAXATION OF DIVIDENDS AND SPECIAL TAX PROVISIONS FOR THE SALE OF STOCK IN CANADIAN FIRMS TO EMPLOYEES WAS PART OF THIS STRATEGY.

11. SEEN FROM THIS VIEWPOINT, THE BANK RATE REDUCTION FITS WELL INTO THE EXISTING POLICY STANCE IN ENCOURAGING INVESTMENT RATHER THAN CONSUMPTION, DOMESTIC BORROWING RATHER THAN FOREIGN, AND GREATER EQUITY FINANCING RATHER THAN DEBT. ENDERS

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